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No. 544

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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 544

ARTHUR H. SHAFFER AND M. JAMES SPITZER,
PETITIONERS

v.

C. GORDON ANDERSON, AS TRUSTEE IN REORGANIZATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION[1]

OPINION BELOW

The opinion of the Court of Appeals (Pet. App. 1a–11a) is reported at 292 F. 2d 455. There was no opinion of the District Court.

JURISDICTION

The judgment of the Court of Appeals was entered on July 7, 1961 (Pet. App. 1a). A petition for rehearing was denied on August 18, 1961 (Pet. App.

[1] The Securities and Exchange Commission was a party in the district court pursuant to Section 208 of the Bankruptcy Act and participated as an appellee in the court of appeals by filing a brief and by oral argument.

13a). The petition for a writ of certiorari was filed on November 13, 1961. The jurisdiction of this Court is invoked under Section 24c of the Bankruptcy Act, 11 U.S.C. 47c, and 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, in a proceeding under Chapter X of the Bankruptcy Act, the district judge, prior to consummation of a plan of reorganization, may vacate his order confirming the plan because of facts existing at the time of confirmation, not then known to the district judge but subsequently disclosed, which rendered the plan unfair.

STATUTE INVOLVED

Pertinent provisions of the Bankruptcy Act (52 Stat. 840, 11 U.S.C. 1, *et seq.*) are set forth in the Appendix, *infra*, pages 15–16.

STATEMENT

This case involves the validity of a district court order which vacated a previous order confirming a plan of reorganization of TMT Trailer Ferry, Inc. ("the debtor"), a company being reorganized under Chapter X of the Bankruptcy Act in the United States District Court for the Southern District of Florida.

The reorganization proceeding was initiated on June 27, 1957, by the filing by creditors of a petition for reorganization (R. 21).[1] The petition was ap-

[1] "R." refers to the printed transcript of record in the court of appeals.

proved on November 15, 1957, and a trustee was appointed (R. 25). A plan of reorganization was filed by the trustee on August 29, 1958 and subsequently was amended (R. 88–120, 138–162). As ultimately amended, it provided that the stockholders would not participate in the reorganized corporation (R. 152) and that control thereof would be given to petitioners Arthur H. Shaffer and M. James Spitzer, and others associated with them (R. 147, 157). Petitioners are indenture trustees under mortgages on various properties of the debtor (herein referred to as "the Caplan mortgage").

On December 19, 1958 the Securities and Exchange Commission filed objections to the trustee's plan of reorganization (R. 123–125). The Commission pointed out, among other things, that the trustee had not made the investigation and report contemplated by Section 167 of the Bankruptcy Act for the purpose of determining the assets and liabilities of the debtor and possible causes of action on its behalf; and that no record had been made with respect to prospective earnings and the value of the debtor's assets to provide a basis for determining whether, under the standard of Section 174, the plan was "fair and equitable." A Protective Committee for Independent Stockholders also filed similar objections (R. 126–134).

The plan was approved by the district judge on January 15, 1959 (R. 135–137).

After the plan had been submitted for acceptance to creditors, the Commission objected to confirmation for substantially the same reasons for which it had

objected to approval (R. 169–171). On March 6, 1959, the district judge confirmed the plan (R. 181–185).[3]

Prior to confirmation there had been rumors that the then indenture trustee under the Caplan mortgage was acting for one Joseph Abrams, who was believed to be largely responsible for the debtor's financial difficulties (R. 180). After confirmation, the Commission filed on January 8, 1960, a petition requesting an order (1) staying consummation of the plan, and (2) directing the trustee (a) to make a detailed investigation and report of the debtor's affairs and (b) to institute suit to recover any money or property improperly taken from the debtor (R. 219–224). Attached to the petition was an affidavit by a financial analyst of the Commission (R. 224–230) which showed that prior to the reorganization Abrams had acquired large amounts of the debtor's securities at prices substantially under the market, and that while Abrams was a substantial stockholder he or his associates had entered into certain improper transactions with the company. The affidavit also suggested that Abrams

[3] The Protective Committee appealed from the order of confirmation on the grounds that there had not been a hearing as to the insolvency of the debtor, and that the court had failed to order an investigation by the trustee pursuant to Section 167 and to make findings as to the value of the debtor's assets and its prospective earnings (R. 206–207). This appeal was subsequently stayed by agreement, pending the investigation referred to in the text, *infra*. The Committee's appeal was argued in the court of appeals together with the appeal from the district court orders that petitioners now seek to review in this Court. In view of its affirmance of the latter orders, the court of appeals held that the appeal by the Protective Committee was moot (Pet. App. 6a).

and his associates were the owners of the Caplan mortgage and, hence, under the confirmed plan of reorganization would obtain control of the reorganized debtor (R. 224–230). Upon the filing of this affidavit all parties consented to an investigation by the trustee (R. 258), which the court ordered on January 22, 1960 (R. 245).

The trustee, with the assistance of members of the Commission's staff, conducted an investigation from January until May 1960. The inquiry was conducted primarily through depositions, and all creditors and stockholders represented in the reorganization were permited to participate. Testimony of thirty-three witnesses covering 2200 pages was taken and sixty exhibits were received (R. 259–260).

On July 1, 1960, the trustee filed a lengthy report (R. 255–295), in which he concluded that the debtor's business "was wrecked by gross mismanagement, by unwise and unsound expansion financed primarily through the sale of securities in disregard of the protective provisions of the Securities Act of 1933" (R. 260). He stated that the Caplan mortgage group, which would have controlled the company under the plan, is dominated by Shaffer, one of the successor indenture trustees; and that Shaffer and Abrams had speculated and profited greatly from sales of the debtor's stock made in violation of the Securities Act of 1933 (R. 262, 263, 265, 281). The report also revealed various questionable transactions between the debtor and Abrams and his associates, and concluded that substantial causes of action existed against Abrams

for his role in causing the acquisition by the debtor of certain property in Wilmington, Delaware (R. 266–270, 291–292).

The trustee also reported that "causes of action and defenses exist against the holders of the Caplan mortgage, individually and as a group, which should affect their status as creditors and stockholders"; and that that mortgage "was a fraudulent transfer as defined by Section 67(d)(2) of the Bankruptcy Act (11 U.S.C. 107(d)(2))" (R. 282). The trustee concluded that the order confirming the plan of reorganization should be vacated on the ground that the plan was not fair and equitable; that he should be permitted to object to the claims based on the Caplan mortgage; and that he should be permitted to institute proceedings to recover damages against Abrams and Shaffer as well as for other relief (R. 294–295).

On August 15, 1960, the district court approved the trustee's recommendations, and entered an order which, among other things, vacated and set aside the prior order of March 6, 1959, confirming the earlier plan (R. 324–325). The order stated (R. 325):

> It appears from the Trustee's Report that there are substantial questions regarding the status and validity of the claims of persons who have been accorded participation under the confirmed plan of reorganization. It further appears that the Trustee's investigation disclosed facts not known to the Trustee or to the Court at the time the plan was confirmed, and that such facts in the opinion of the Trustee render the plan not fair and equitable. No rights

> have vested under the existing plan and no creditors or stockholders will be prejudiced by setting the plan aside and permitting the Trustee to submit another one.

The Court of Appeals for the Fifth Circuit unanimously affirmed the order vacating the previous order of confirmation.[*] Relying on this Court's decision in *Pfister* v. *Northern Illinois Finance Corp.*, 317 U.S. 144, 152, the court held that "unless there has been such consummation that a modification would unfairly affect the complaining party he cannot successfully resist a decision by the trial court for good cause shown to withdraw its prior approval" (Pet. App. 9a). The court ruled that "[h]ere no intervening rights had accrued"; that "sufficient showing was made to warrant the court's decision that its earlier order of confirmation was not for the best interests of the parties * * *"; and that "neither the court nor its officer is barred by laches from proceeding with a proper administration of the debtor's affairs" (Pet. App. 10a).

ARGUMENT

The court of appeals held that the district court, at a time when the plan of reorganization had not been consummated and no rights had accrued thereunder, properly had vacated its earlier order of confirmation, because of facts, not known to it when it confirmed the plan but subsequently disclosed, which apparently

[*] The court of appeals also affirmed certain administrative orders of the district court (Pet. App. 10a–11a). No review has been sought of those rulings.

rendered the plan unfair. That holding is correct, is supported by the decisions of this Court, and is not in conflict with the decision of any court of appeals. There is accordingly no occasion for further review.

1. In ruling that judicial approval of a confirmed but unconsummated plan of reorganization may be vacated for good cause, where no intervening rights had accrued, the court of appeals properly applied, to the facts of this case, the settled principle that

> * * * The entire process of rehabilitation, reorganization or liquidation is open to reexamination out of time by the District Court, in its discretion, and subject to intervening rights. [*Pfister* v. *Northern Illinois Finance Corp.*, 317 U.S. 144, 152.]

The reason for the district court's "reexamination" of the plan and the vacation of its order of confirmation was the discovery, through a belated investigation pursuant to Section 167 of the Act, of certain facts which made the plan unfair (see Statement, *supra*, pp. 5–6).[5] Had these facts been uncovered before approval of the plan—as they pre-

[5] There is no basis for petitioners' charge (Pet. 18) that, in vacating the order of confirmation, "the District Court disregarded even the rudimentary requirements of a judicial hearing." On the contrary, prior to vacating the confirmation order the district judge ordered a hearing on the trustee's report of investigation "to consider and determine what action shall be taken in regard to the recommendations made by the trustee in said Report" (R. 296) (which included a recommendation that the order confirming the plan be vacated (R. 294)): notice thereof was sent to all stockholders and creditors (R. 297–298) and the court heard argument of counsel (R. 325). Although the report contains sixty-eight detailed factual allegations (R. 255–294), the answer filed by petitioners on the date

sumably would have been had there been the thorough investigation contemplated by the statute"—it may be assumed that there would have been no approval or confirmation since both of these actions require a determination that the plan be "fair and equitable, and feasible." Sections 174, 221(2). A plan is not fair which permits participation by insiders who have breached their fiduciary obligations to the debtor prior to participation by public security holders whom they have injured. *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307; *Pepper* v. *Litton*, 308 U.S. 295. Furthermore, the basic determinations of fairness and feasibility may be made only on a full record so that there may be an informed estimate as to future earnings. *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510, 524–526; *Securities and Exchange Commission* v. *United States Realty & Improvement Co.*, 310 U.S. 434, 456. No such record had been made when the district judge in this case approved and confirmed the plan.

In view of the trustee's conclusions (see *supra*, pp. 5–6) that there had been "gross mismanagement" which had "wrecked" the debtor's business, and that

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of the hearing did not attempt to refute any of them. It merely stated that the report was "contrary to the evidence in respect of its purported findings and conclusions" (R. 298).

"The importance of such an investigation has been repeatedly emphasized by this Court. See *Securities and Exchange Commission* v. *United States Realty & Improvement Co.*, 310 U.S. 434, 451, 454; *General Stores Corporation* v. *Shlensky*, 350 U.S. 462, 467. See, also, *Committee* v. *Kent*, 143 F. 2d 684, 687 (C.A. 4).

Shaffer and Abrams had profited from illegal sales of the debtor's stock, the district court was fully warranted in concluding that "there are substantial questions regarding the status and validity of the claims of persons who have been accorded participation under the confirmed plan of reorganization" (R. 325). In these circumstances, the court properly vacated its prior order of confirmation, and ordered the trustee to submit a new plan (*ibid.*).

There is no merit to petitioners' contention (Pet. 16–18) that they had vested rights under the confirmed plan that could not be disturbed. The argument rests on the claim that, when the trustee filed with the court his original plan under which the interests which petitioners represented would have obtained control of the debtor, they withdrew a pending appeal from an order directing an investigation into "the validity, amount, and priority" of their claims and refrained from taking other steps by which they allegedly might have defeated the reorganization (Pet. 4, 16–18). But interests under a plan do not vest until consummation. Sections 222 and 229 of the Act contemplate alterations of a plan that may materially affect the interests of participants made after confirmation and prior to substantial consummation, and Section 57k specifically authorizes reconsideration of allowed claims at any time before the estate has been closed.[1] The only cases cited by petitioners holding that rights flowing from a plan of reorganization have

[1] And see *Knight* v. *Wertheim & Co.*, 158 F. 2d 838, 842 (C.A. 2), to the effect that the "order of 'confirmation' is not conclusive."

vested relate to situations where consummation had occurred.[8] Furthermore, even if the fact that petitioners may have given up a strategic position in reliance upon the submission of a plan could be deemed a settlement, it is clear that any settlement or compromise in a Chapter X proceeding, like the plan of reorganization itself, must be based on an "informed, independent judgment," which was wholly lacking here. *Ashbach* v. *Kirtley*, 289 F. 2d 159, 166, (C.A. 8), citing *National Surety Company* v. *Coriell*, 289 U.S. 426, 436.[9]

Since rights had not vested and the proceeding was still continuing, the district court, as a court of equity,[10] could correct its prior mistakes.

2. The decision below is not in conflict with any of the courts of appeals' decisions cited at page 12 of the petition. Both *In re Inland Gas Corporation*, 275 F. 2d 509 (C.A. 6) and *Knight* v. *Wertheim & Co.*, 158 F. 2d 838 (C.A. 2) involved situations where it was alleged that an increase in the value of the debtor's property occurring subsequent to confirmation made the plan unfair. In *Inland* the court characterized the confirmed plan as "sound" (275 F. 2d at 513), and

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[8] See *Hanssen* v. *Wingren*, 121 F. 2d 1011, 1013 (C.A. 10); *In re Burton Coal Co.*, 57 F. Supp. 361, 362, 363 (N.D. Ill.); *Standard Steel Works* v. *American Pipe & Steel Corp.*, 111 F. 2d 1000, 1001, 1002 (C.A. 9).

[9] Cf. also *First National Bank* v. *Flershem*, 290 U.S. 504, 525; *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 115; *Consolidated Rock Products Co.* v. *DuBois*, *supra*, 312 U.S. at 520.

[10] See Section 115 of Chapter X. See also *Securities and Exchange Commission* v. *United States Realty & Improvement Co.*, *supra*, 310 U.S. at 455.

in *Knight*, the court noted that "the rise in value of the debtor's property" could not have been foreseen at confirmation (158 F. 2d at 843). In each of those cases, therefore, it was held that the plan as originally confirmed was fair, and the original order of confirmation was proper; the claim was that subsequent events made the plan unfair, and that the order of confirmation should therefore be vacated. In the present case, on the other hand, the original order of confirmation was improper, since if all the material facts in existence at the time of confirmation had been known to the district court, it would not have approved and confirmed the plan as fair. The two other cases are even less applicable.[11]

Nor does the decision below conflict with the cases cited at page 19 of the petition for the proposition that the trustee was estopped or precluded by laches from attacking the confirmed plan of reorganization. *Nichols* v. *Alker*, 231 F. 2d 68, 79 (C.A. 2), was based not upon alleged laches or lack of diligence of those who attacked the plan—indeed, the court's opinion makes clear that they had been continuously attacking the plan—but upon the fact that the challenge to the plan in that case "was brought in violation of the injunction in the reorganization decree," which related to a plan that had already been consummated. The

[11] *Country Life Apartments* v. *Buckley*, 145 F. 2d 935 (C.A. 2), held that a district judge properly refused to permit the filing of an alternative plan at a hearing on confirmation of the trustee's plan. *In re Diversey Building Corporation*, 141 F. 2d 65 (C.A. 7), merely held that a district judge properly denied a motion refusing to permit a plan to be amended which had been consummated almost eight years earlier.

other cases do not involve corporate reorganization proceedings. This Court has pointed out that considerations of the sort urged by petitioners are not to be applied in reorganization proceedings to the detriment of public investors. See *Comstock* v. *Group of Investors*, 335 U.S. 211, 226–228:

> We think that, in the reorganization proceeding, the courts may entertain on their merits objections to a plan even if made by one who might be barred from asserting a cause of action in his own behalf, if the subject-matter of the objections is such that it goes beyond the objector's individual interests and affects the fairness and equity of the plan.
>
> * * * * * *
>
> The court will be diligent to protect itself and the public from approval of unfair plans, even by default, and may take for its own use evidence no party would have a right to force upon it.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER 1961.

APPENDIX

THE BANKRUPTCY ACT

(52 Stat. 840, 11 U.S.C. 1, *et seq.*)

Sec. 167 [11 U.S.C. 567].

The trustee upon his appointment and qualification—

(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;

(2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;

(3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;

* * * * *

(5) shall, at the earliest date practicable, prepare and submit a brief statement of his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, in such form and manner as the judge may direct, to the creditors, stockholders, indenture trustees, the Securities and Exchange Commis-

sion, and such other persons as the judge may designate; and * * *.

Sec. 229 [11 U.S.C. 629].

a. A plan shall be deemed to have been substantially consummated if, insofar as applicable, each of the following events has occurred:

(1) transfer, sale or other disposition of all or substantially all of the property dealt with by the plan pursuant to the provisions of the plan;

(2) assumption of operation of the business and management of all or substantially all of the property dealt with by the plan by the debtor or by the corporation used for the purpose of carrying out the plan; and

(3) commencement of the distribution to creditors and stockholders, affected by the plan, of the cash and securities specified in the plan as provided for in section 224 of this Act.

b. Upon notice to the trustee, the debtor, the Securities and Exchange Commission and such other persons as the judge may designate, the trustee, the debtor in possession, the corporation to which the assets of the debtor are to be transferred under the plan, or any other party in interest may apply to the judge for an order declaring the plan to have been substantially consummated under the provisions of subdivision a of this section.

c. When a plan has been substantially consummated as defined in subdivision a of this section, or an order has been entered under subdivision b of this section, the plan may not thereafter be altered or modified if the proposed alteration or modification materially and adversely affects the participation provided for any class of creditors or stockholders by the plan.

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